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TAGS: [ECON](#) [EFIN](#) [AR](#)  
SUBJECT: FISCAL SITUATION IN PROVINCES DETERIORATING

REF: 04 BUENOS AIRES 2601

¶1. (U) Classified by Ambassador Lino Gutierrez for reasons  
1.4 b and d.

¶2. (C) Summary: Provincial finances are deteriorating,  
with the provincial contribution to the consolidated surplus  
this year projected to be zero. The worsening state of  
provincial finances is mainly the result of spending  
increasing faster than revenues. Spending is being driven by  
salary increases, with public sector unions demanding the  
same 19 percent increase given to federal workers. Salaries  
account for 50 percent or more of spending in most provinces.  
Debt payments also are growing, because 70 percent of  
provincial debt is inflation-indexed debt owed to the GOA.  
The Fiscal Responsibility Law (FRL) is not being enforced,  
and the new Education Financing Law conflicts with the FRL.  
This worrisome trend comes on top of an unprecedented four  
years of provincial and federal surpluses, and the federal  
surplus remains relatively strong. In a political sense,  
President Nestor Kirchner stands to gain from provincial  
fiscal weakness and has no incentive to reform the fiscal  
system, despite its financial and institutional weaknesses.  
Provincial finances are based on the Co-Participation revenue  
sharing system, whose formulas have not been changed since  
1988, and most provinces depend on additional discretionary  
transfers from the GOA. Kirchner has been very adept at using  
discretionary transfers (or withholding them) to bring  
governors into line. It is no surprise that the major  
provincial opposition figures all come from provinces  
(Neuquen, Salta, San Luis) that have oil or other revenue  
sources that are independent of GOA discretionary transfers.  
End summary.

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Fiscal Accounts are Getting Weaker  
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¶1. (U) Provinces are projecting a worsening fiscal situation  
for 2006, with an overall primary surplus near zero. Felipe  
Sola, the Governor of Buenos Aires Province, said in June  
that the province, which contains 38 percent of the  
population, closed the first quarter in deficit and predicted  
an overall primary deficit this year. Broda consulting  
firm,s latest estimates put the total primary provincial  
surplus at just ARP 274 million (0.4 percent of GDP) for  
2006, down from ARP 4.0 billion (0.8 percent of GDP) in 2005.  
After accounting for interest payments, Broda predicts a  
financial result of ARP -1.9 billion (-0.3 percent of GDP),  
compared with a surplus of ARP 2.1 billion (0.4 percent of  
GDP) in 2005. Other sources (Economia & Regiones, Fundacion  
Mediterranea) have made similar estimates. Provincial  
surpluses have been shrinking since their peak in 2004 when,  
according to Broda, they had a primary surplus of 1.4 percent  
of GDP and a financial surplus of 1.1 percent of GDP.

¶2. (U) Much of the deterioration in provincial accounts is

due to the rise in provincial expenditures outstripping revenue growth. Broda calculates that provincial spending has increased by 31 percent since 2003. Initially following the devaluation, the increase in provincial tax collections far surpassed rising spending; first-quarter collections in 2003 were 55.9 percent higher than the year before, according to the consulting firm Economia & Regiones. They have failed to keep pace with rising expenditures more recently, however, as provincial collections rose only 23 percent y-o-y in 2005 and in 2006.

¶3. (U) Spending on public employees made up nearly half of the increase in expenditures during the past two years, primarily through salary increases. Public works spending has risen at an even faster rate, but its effect on the overall budget situation has been less pronounced because it only makes up 11 percent of total provincial expenditures, according to Economia & Regiones.

¶4. (U) Broda's budget projections are based on a 19 percent increase in provincial public sector salaries. The GOA announced a 19 percent salary increase for its public employees this year, which drew immediate criticism from provincial governors who were quick to realize it would be politically difficult not to follow suit. Kirchner served as governor of Santa Cruz province for three terms before being elected president, so he is well aware of the effect the GOA salary increase will have on provincial finances. The question is whether he is indifferent or whether he saw the difficulties it would cause to be politically advantageous, as provinces in need of GOA funds are unlikely to put up much opposition to Kirchner's policies.

¶5. (U) The fiscal situation remains more positive at the national level, although rising federal government expenditures outpaced collections in the first quarter of 2006 for the first time during the Kirchner Administration. Between 2003 and 2005, nominal federal expenditures rose 25.6 percent per year and real expenditures rose 16 percent annually. By comparison, nominal expenditures rose an average of only 4.8 percent and real expenditures rose 3.8 percent annually in the nine years leading up to the 2002 devaluation (1993-2001). Broda predicts that the primary budget surplus will fall from 3.7 percent of GDP in 2005 to 3.2 percent of GDP this year. Though the surplus is shrinking, the GOA's budget is in good shape compared with the large fiscal deficits that characterize its recent history.

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Debt Payments are Growing  
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¶6. (U) In addition to increasing expenditures, provinces are still paying off an accumulated debt worth USD 10.9 billion, according to the Ministry of Economy, held primarily by the GOA. The provinces owe 70 percent of their debt to the GOA for external debts the GOA assumed in 2002. Their ability to repay their loans hinges on their fiscal situation. Economia & Regiones estimates that provinces will need an additional ARP 7.0 billion this year in order to make debt payments. The GOA-assumed provincial debt is indexed to CER (an inflation-linked index), and this indexation has drawn significant criticism from provincial leaders as inflation has doubled in each of the past three years, and is projected to be near 11 percent in 2006. According to press report, some provinces managed to renegotiate the terms of their debt with the GOA to remove this indexation provision, but this is at the discretion of the GOA and, ultimately, of President Kirchner.

¶7. (U) Provinces have also complained that the GOA owes them ARP 3 billion in collections currently sitting in the National Treasury Contributions (ATN) fund. Approximately two percent of tax collections are earmarked for this fund, which is then handed by the Ministry of the Interior in case of "emergency situations" or to resolve "financial imbalances in provincial governments." These guidelines have had little effect, and often these funds have been used as political

leverage with provincial leaders. Provincial leaders and members of Congress have called for reforms, but action seems unlikely in the coming months.

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Fiscal Responsibility Law not Being Enforced  
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¶18. (U) The GOA passed the Fiscal Responsibility Law (FRL) in ¶2004. In theory, the law holds both provincial and national governments more accountable for their spending. The law went into effect in the beginning of 2005 for provinces only, as the GOA exempted itself from the FRL in the 2005 and 2006 budgets. The FRL requires, among other things, that spending increase no faster than the rate of nominal GDP growth. One year later, however, only half of provinces have managed to meet this requirement. A provision in the FRL for a program to bring non-complying provinces into compliance has not been implemented.

¶19. (SBU) The Education Financing Law, which went into effect this January, stipulates that provinces must increase education funding to a level of six percent of GDP in the next five years. Many provinces say that the Education Law, by mandating increases in provincial spending, stands in direct conflict with the FRL. The GOA transferred responsibility for education and health funding to the provinces in the 1990s, but there were no adjustments in co-participation revenues to adjust for this transfer, because the co-participation system is extremely difficult to change. Instead, the adjustment mechanism has been National Treasury Contributions (ATN) funds and annual bilateral provincial-GOA pacts in which the GOA agrees to transfer federal resources to selected provinces. Both of these have been sources of federal fiscal leverage over provincial governments.

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Comment:  
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¶10. (C) Revenues in Argentina are strongly pro-cyclical. GDP growth remains strong -- estimated at 7-8 percent for 2006 by the Central Bank of Argentina -- but it is decelerating. If collections drop, it may be politically difficult for national or provincial governments to compensate by reducing expenditures. Both national and provincial spending tend to rise in election years, and the presidential elections in 2007 are unlike to deviate from that trend. Four years of provincial and federal fiscal surpluses in the provinces is an unprecedented achievement, even if the surpluses are shrinking.

¶11. (C) President Kirchner is often lauded for his fiscal management, but it also is fair to say that Kirchner is a very good politician, and that he has used the GOA,s fiscal powers very well to exert political control over governors and provincial parties. President Kirchner, as a long-time governor, certainly understood that the 19 percent salary increase he approved for federal employees would create financial problems for many provinces to follow. In most provinces, salaries constitute 50 percent or more of expenditures. But in a political sense, Kirchner stands to gain from provincial fiscal weakness. Kirchner has held up federal transfers promised under bilateral pacts when governors do things he does not like (e.g., he cut off funds to La Rioja governor Maza in 2003 after Maza appeared at a public event with former president Menem, and Maza was unable to make his payroll; shortly thereafter, Maza became Kirchner,s candidate in La Rioja). He has also used provincial indebtedness to the GOA and delays in ATN transfers to remind governors who controls the money that they need. This has played in some cases in convincing Radical Party governors to cross party lines and support Kirchner. It is no surprise that the major provincial opposition figures all come from provinces (Neuquen, Salta, San Luis) that have oil or other revenue sources that are independent of GOA discretionary transfers.

¶12. (C) In an institutional sense, Argentina,s Co-Participation revenue system, in which the GOA collects all revenues and returns a portion of them to the provinces through a set formula, has the perverse and undemocratic effect of divorcing provincial politics from taxation. It also magnifies the power of the President, since the Co-Participation formulas have not been adjusted since 1988, and most provinces therefore depend on additional transfers from the GOA to balance their books. The 1994 constitution calls for the Co-Participation formulas to be amended, but this has proven politically impossible for successive administrations. Reftel A provides a detailed explanation of the process of reforming the Co-Participation law, which requires absolute majorities in both houses of Congress and ratification by the legislatures every province. While Kirchner may be the first president since 1994 who has the political power to push through changes to the Co-Participation formula, he lacks any domestic political incentive to do so, and his decision to pay off the IMF removed the only external pressure for change.

¶12. To see more Buenos Aires reporting visit our classified website at: <http://www.state.sgov.gov/p/wha/buenosaires.< /a>>  
GUTIERREZ